Mr Borden

Borden
a good brief

A Submission To

C-27-4

The Royal Commission On Energy

February, 1958

by

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Banff Oil Ltd.

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INTRODUCTION

Mr. Chairman, I appear before you today as the spokesman for a group of independent producers, all of whom are members of the Canadian Petroleum Association and all of whom support the brief submitted by the Association.

We feel that independent producers, as such, have certain problems and points of view (which were not dealt with in the Canadian Petroleum Association brief) and which will be of interest to the Commission.

For the purposes of this submission, an independent producer is one which is of minor significance in the total world industry. Though it might even carry on an integrated operation from oil field to gasoline pump, it is engaged in the exploration for, and development of, oil and gas reserves, and this is the distinguishing difference, *the independent depends upon the oil and gas resources of Canada for its income.* This is, of course, in contrast to the companies with operations or affiliations which are international in scope.

An international company, if it finds production restricted in one country, can draw more heavily from reserves located elsewhere. We cannot do that.

If reserves in one area or country appear insecure for political or military reasons, an international company can produce its reserves faster in the area which is insecure, and retain its reserves in areas which appear safer. We cannot do that.

Since our area of interest is here in Canada, we are more directly influenced by whatever policies are in effect in Canada. Our economic and political interests are more closely identified with those of the provinces and the nation in which we do business. For this reason we feel that the views of the independent producers are of unique importance to the Commission.

We propose to discuss some of the problems of the oil and gas industry which are of urgent concern to the public and to the government of Canada, and particularly of Western Canada. We will discuss the part played by the independent producers, and will make recommendations under three different headings.

1. Oil.

2. Natural Gas.

3. Taxation and finance.

As independent producers, we make decisions of a long term nature, but they must often be governed by short-term business considerations. For example, the decision to drill a well may involve us in obligations to drill many additional wells. The decision can only be justified on the assumption that our capital will be returned in a reasonable time and that the production thereafter will be fast enough and continue long enough to result in a satisfactory over-all profit. In the gas industry, we may sign contracts which commit our reserves for 25 years ahead, but until these contracts result in gas sales, we derive no revenue toward the repayment of our capital cost.

In exploration, we do everything possible to spread our risks. Still, this can be done adequately only when capital is sufficient to maintain an active exploration program over an extended period of time. The law of averages is the application of large numbers. The resources of an international company permit it to conduct a program of the size and duration which almost guarantees results. The independents, taken as a group, can do the same thing. But for any *one* independent company, the law of averages is no assurance of success.

The search for oil and gas is a highly uncertain business, in which neither a major company nor an independent can be sure what lies beneath the ground. Oil and gas are where you find them, and all of us, major or independent, have a chance at success, even though the odds favour those with the greater resources.

Although he may share with the majors the risks of exploration, an independent producer must conduct himself differently. He endeavours to build a foundation of producing assets which, while they are depleting, will return his capital within a few years and allow him sufficient funds to remain active in exploration. For any independent, each venture is of great importance. He cannot exist for long periods without revenue from production.

In addition to the normal risks in our business, there are outside uncertainties more difficult to deal with. For instance, changes in policies, or the actions of foreign governments are often unpredictable. The closing of the Suez Canal conferred a very temporary benefit on producers in Canada. The imposition of oil import quotas by the United States could have the opposite effect. When faced with such abrupt changes, an international company can adapt itself more easily than we can.

We do not for a moment suggest that the independent producer is seeking special considerations. We simply wish to leave the commission with the impression that we are *different.* While we share with the major companies many of the same risks and uncertainties, we operate in many

ways at a disadvantage. The disadvantages are further increased by some shortcomings in the Canadian capital market and in taxation policy because these bear more heavily upon the Canadian independent producers than upon international companies operating here. We will have some suggestions to make on this subject later in our brief.

In spite of certain handicaps, the independent producers have played a leading role in the search for oil and gas in Western Canada. We have not been able to prepare accurate figures for the amount of money spent on preliminary exploration, in which the major companies have been more active than the independents, nor for expenditures on drilling. We have prepared a table showing the number of wildcat wells drilled in each of the prairie provinces in each year from 1949 to 1957. Every wildcat well, whether successful or not, provides valuable information for the industry. The table which follows will give the commission a measure of the activity of the independents, and their contribution to developing the oil and gas resources of Canada.

NUMBER OF WILDCAT WELLS

DRILLED BY MAJOR AND INDEPENDENT COMPANIES

PRAIRIE PROVINCES 1949 - 1957

	ALBERTA		SASKATCHEWAN		MANITOBA		TOTAL	
	Major	Independent	Major	Independent	Major	Independent	Major	Independent
1949	90	110	3	11	0	3	93	124
1950	83	133	15	25	1	3	99	161
1951	127	212	25	36	7	2	159	250
1952	129	283	142	70	23	13	294	366
1953	128	159	189	63	4	21	321	243
1954	179	156	246	73	11	70	436	299
1955	188	150	231	77	14	43	433	270
1956	223	149	193	131	16	28	432	308
1957	285	163	282	264	*	*	567	427
TOTAL	1432	1515	1326	750	76	183	2834	2448

* Not available.

These figures are derived from data in the yearbooks of The National Oil Scouts and Landmen's Association and are true wildcats, in the sense that extensions of existing fields, or new pay discoveries drilled in such field areas, are not included.

First, the figures show that, from the years 1949 to 1952, inclusive, approximately 60 per cent of the wildcat wells were drilled by independents.

Secondly, in the past nine years, over 45 per cent of the wildcat wells were drilled by independents.

The Commission will note that in the past two years there has been a sharp increase in wildcat drilling by independents in Saskatchewan. This reflects the fact that the economics of oil production in Alberta have become less attractive. Alberta production, as a percentage of the productive capacity of the wells, has declined from 71 per cent in 1954 to 51 per cent in 1957 and to only 45 per cent today. A chart of this relationship forms Appendix 1 of our submission.

The fact that the independents, in the past nine years, have drilled almost half of all the wildcat wells in the prairie provinces, makes our point clear. The independents are a dynamic force in the development of Canada's petroleum resources.

The independent companies maintain this activity partly because they are smaller. They need not make recommendations to a distant committee and await approval. Ordinarily, they are more flexible, and probably faster to react to opportunity. Similarly, because their funds are limited, they must have an active policy regarding acreage. They must acquire acreage where it is cheap, in areas not yet explored. They usually test the acreage quickly, or farm it out to others, in order to be free to move on to new areas. These factors create activity which speeds up the whole process of exploration and discovery.

The contribution made by the independents is direct and measurable, as we have shown, as well as indirect in stimulating the activity of others. With this background we will now discuss the oil phase of our business.

OIL

Your commission sits at a critical time. According to press reports, two committees of the United States Congress are sitting to investigate Canadian-American relations, while another committee in that country sits to rewrite the United States Reciprocal Trade Agreements Act. This Committee will hear arguments relating to imports into the United States. They will try to decide whether it is in the long run interest of the United States that her imports from friendly countries, and oil from Canada is one example, should continue to be encouraged during one year and barred during the next. The newspapers report that a well known Senator has called for legislation which would formalize restrictions on the import of oil from, among other places, Canada. And amid this bustle, Canada's protests go unheeded.

Meanwhile we seem to be slipping into the downswing of the business cycle. Since the end of World War II there have been two minor recessions — 1949 and 1954. In 1949, Canada's oil production was still expanding to serve available domestic markets. In 1954 the effect of the recession was felt in the Canadian oil industry in the clamour of United States oil producers for restrictions. Since that time, voluntary restrictive measures have been devised. Now, in the downswing of 1957-58, they may be made mandatory.

There is an apparent over-supply of oil in the United States today. It is natural, if not statesmanlike, to seek to restrict the suppply of oil in these circumstances — and that is what United States oil producers have done. But, however we may deplore the symptoms of the business cycle, it is with us — and so are restrictions on the markets for Canadian oil exports.

We recognize that in the long run we should be able to export large quantities of oil to the United States — some say as much as 1,600,000 barrels per day by 1980.

What really concerns us now, is *how long* will it be before Canadian oil will again move more freely over the border. If limitation of oil imports is made law, an early reversal of this philosophy can hardly be expected, and Canada's oil exports to the United States could be restricted indefinitely.

To the extent that markets for Canadian crude oil are restricted, the exploration and development of Canada's petroleum resources will be curtailed. From our earlier remarks about the financial problems of the independents, it is apparent that, under restrictions, the following will probably occur:

(1) The independents will not be able to carry on their share of exploration, and they will retain only a diminishing share of the country's reserves, production and acreage.

(2) Throughout Western Canada, there will be a drying up of oil exploration and development, with all that that implies in lower revenues, lower royalities, lower personal income, reduced capital investment and the adverse effect on allied services and related industry.

Therefore we see that the present pressure of slackening economic activity calls for immediate action.

We can make decisions of a business or economic nature. Where this is not possible, we can explore the opportunities which might be created by actions of a political nature. In either case, these can relate to domestic markets for the product, or they can be directed to expanding our markets outside the country.

A careful consideration of these various avenues leads us to make the following suggestions to the commission:

We suggest that the pressing urgency of the situation points out the need for immediate and renewed diplomatic representations at the very highest levels of government in an attempt to come to an agreement with the United States government which will permit us to expand our markets for oil on a sound and continuing basis.

It is on record that the Canadian government does not agree with, nor admit the validity of, the concepts of defense used by the United States to justify quotas on oil imports. Perhaps it remains to consider whether real advantages continue to accrue to Canada by our willingness to accept the principle of North American defense on a continental basis when this principle is apparently not accepted elsewhere. Perhaps if these matters were dealt with by a Treaty between our two countries, our relations would not continually be upset by administrative edict.

The United States government may not be able to give Canadian oil preferential treatment over oil produced in other foreign countries, unless it can be persuaded to include oil in both our countries as an item of continental defense recognized in a Treaty.

If representations along this line are unsuccessful we should seek an agreement which will move more Canadian oil into our logical markets in the mid-continent area of the United States and the Pacific Northwest. In exchange, we could continue to accept non-Canadian oil into the markets of Eastern Canada.

At the very least we should seek some assurance that we will not continue to be regarded as a marginal supplier in the very areas we can serve most economically. The United States mid-continent area, including Chicago-Detroit-Toledo, can be readily served by Canadian crude, because our oil-producing areas are so close to the mid-continent market. The Pacific Northwest, because it has access to tankers from abroad, may not find us the cheapest source at all times, but on a long-term basis we are the closest and the safest and we are a logical supplier. The logistics of the movement of oil do not change simply because natural markets lie across a political boundary. They can be interfered with, however, by a tariff, such as the 10½ cents per barrel tariff which the United States now imposes on Canadian crude. We suggest to the Commission that Canada should seek to persuade the United States that this tariff has no place in the relationship between our two countries, and should be eliminated.

As far as our markets here in Canada are concerned, we are now supplying all refineries as far east as Toronto, and if the refineries in that area ultimately supply the requirements of all Ontario, we stand to benefit.

We sympathize with the people and industries of Quebec and the Maritimes when we consider their exposed position in the event foreign oil is unobtainable. The seizure of the Abadan refineries a few years ago and the closure of Suez in 1956 caused very serious disruptions. Already in 1958 we have seen a revolution in Venezuela, the partial seizure of the oil producing and refining facilities in Indonesia by the national government, and the formation of disturbing political alliances in the Arab states. If the markets of eastern Canada were entirely served by Canadian crude oil, these events would cause less concern, and on that basis, the possibility of a pipeline to the Montreal market merits serious consideration.

NATURAL GAS

We would like now to furnish the Commission with some information regarding natural gas.

Our surplus gas is wanted and needed ouside of Alberta. In recent weeks, the commission has heard proposals which bear this out. Such proposals are usually referred to as plans for *export,* which is an unfortunate word, because it suggests to many people that Canada will be deprived of a valuable resource. This is very far from the truth. Export simply means movement of surplus gas out of the Province of Alberta, either east or west to other parts of Canada, or south to the United States. In fact, if all the projects announced are brought to completion, in the order of 50 per cent of Canadian gas will be moving to markets within Canada.

A great deal of gas has been discovered incidental to the search for oil. Because there were limited markets for most of this gas, there has been little incentive to develop it. The nine independent producers represented here today have, between them, invested over eight and one-half million dollars to drill gas wells which are now capped, and in addition, approximately five and one-half million dollars on acquisition, rentals, and exploration in these areas, an aggregate of 14 million dollars. Furthermore, we must make more expenditures of the same type, tie up more money, in order to prevent some of our leases and permits from expiring. We submit that the total locked-in capital of both the majors and the independents has reached a startling figure. Worse than that, reserves which have been committed under contract can be said to be declining in value when export permits are not issued.

If money can earn six per cent, the present worth of our gas in the ground falls by 8/10ths of a cent per 1,000 cubic feet for every year that production is deferred. During the period that our gas reserves are lying idle, the provinces are deprived of royalty revenue, and many people here in Canada are deprived of gas.

The Government of Alberta is fully justified in ensuring that its people have adequate reserves available for their future use before markets outside the Province can be served. But the amount of the reserves available, surplus to the Provincial needs, can be very much influenced by government policy.

Even though there was little incentive to explore for gas, the proven reserves of Alberta, as measured by the Oil & Gas Conservation Board, have jumped from 4.7 trillion cubic feet in 1950 to 21 trillion cubic feet today.

A policy is hardly realistic which fails to recognize that an incentive to search for gas would lead to large scale exploration and greater gas reserves. In this connection, the Commission may welcome some guidance in the interpretation of the figures for gas reserves.

A consideration of natural gas reserves can be divided into:

(a) An estimate of proved reserves of fields or areas, restricted conservatively to the stage of development drilling which such fields have reached.

(b) Probable reserves capable of being developed by further drilling in such fields or areas

and

(c) Reserves in areas yet to be discovered.

A number of estimates in the first category have been presented before this Commission and some long term guesstimates for the Province of Alberta have been advanced by the Board and by the Canadian Petroleum Association in the third category. The proved reserves appear consistent and reasonable and show a marked similarity when allowance is made for minor differences in the bases of the estimates. We would like to make some comparisons which illustrate what these figures can mean in the light of the near term drilling, which would follow the incentive provided by the assurance of expanded markets.

Until the authorization of an export permit to Trans-Canada Pipeline was granted on May 10, 1954 there was no concrete assurance of any expanded high load factor market for natural gas. In spite of this, the entire initial requirements of Trans-Canada, surplus to provincial needs, had been proved at the time the permit was granted.

Let us look at an example of four fields which are closely associated geographically and geologically. As at December 31, 1951 they were allotted proved reserves of 128 billion cubic feet (BCF) by the Board —today the figure is 627 BCF—nearly five times as large. It is interesting to note that these fields namely Kessler, Oyen, Provost and Sibbald are all contracted for early sale of gas to Trans-Canada. In June, 1953 these fields were classified as beyond economic reach and this, we submit, illustrates the fast changing position of many such discovered reserves.

Let us look at a further example of reserve increases in nine fields,* in no way linked with the dedicated reserves for Trans-Canada's needs. These nine fields, essentially undeveloped in mid-1955 (four wells or less in any field), were estimated by the Board as at June 30, 1955 to have total disposable reserves of 583 BCF. As at January 1, 1958, only 30 months later, they were estimated to have 3,488 BCF, nearly six times as large. The majority of these fields are as yet not delineated. These nine fields are a reasonable cross-section of areas which include variable quality and character of reserves, difficulty of access, variable depth and difficulty of drilling, and, therefore, variable investment.

In the Board's estimates for January 1, 1958 are included 65 areas, each of which have four wells or less and no market. The recoverable, disposable reserves attributed to such areas are 4,357 BCF or about 20 per cent of all reserves for Alberta. These are estimated on the limited control of a total of 130 wells drilled in the areas, or an average of 2 wells per area.

Within the 65 areas are Foothills discoveries, discoveries in the deeper part of the basin and also discoveries in relatively shallow horizons‡ similar in setting and characteristics to the nine fields whose growth to date has been illustrated.

We emphatically predict that this growth trend will continue and that it is realistic to visualize, in the near future, a several-fold increase in the present estimates of these sixty-five areas, as well as substantial growth in the development of many of the remaining areas included in the Board's estimates. As to new discoveries, we offer one very current illustration in the Panther River well—in the mountains 63 miles northwest of Calgary—still drilling and having tested a reported 7.2 million cubic feet per day from a *new* productive horizon.

A great majority of increases to the present have been accomplished without assurance of a near term market and complementary return on investment. They have been restricted and minimized in an atmosphere which has certainly fallen short of being stimulating and at times has been contradictory. In such an atmosphere of uncertainty, past growth in the aggregate should not be used as a means of realistically estimating the trend of future growth given adequate markets. It is bound to be unrealistically low. The reserve figures compiled by the

* Beaverhill Lake, Calgary, Carbon, Harmattan-Elkton, Minnehik-Buck Lake, Savanna Creek, Westerose South, Westlock, and Wimborne.

‡ Savanna Creek and Pincher Creek in the foothills—Carson Creek, Crossfield, and Parkland in the deeper basin—and Beaverhill Lake and Westlock as shallow horizon areas.

Board over the years to date, and used in projecting future growth trend, illustrate only the ultra-conservative future growth which will occur in spite of the fact of no assured near term markets.

We further predict that, given the assurance of high load factor markets for gas, presently available reserves, plus additional development of present areas, plus new discoveries from the amply demonstrated potential of the Western Provinces, will provide the supply being sought for available markets today as well as take care of Canada's needs.

Having stated that surplus reserves existing now and in the near future justify immediate expansion of the area being served by Alberta gas, there remain certain points which we would like to make to reinforce our view and to show that export will serve the public interest.

First, we can now sell our gas, a situation which might not necessarily be true at all times in the future.

Secondly, with healthy competition amongst gas purchasers we can obtain favourable prices for our gas. In the United States, old contracts, without escalator and other clauses in the 1930's, have been expiring. Instead of a field price of 4c-5c per thousand cubic feet which made gas such a cheap fuel in the inflationary decades of the 1940's and early 1950's, new contracts are being written at 15c-20c and 22c. Costs of construction, exploration and development are rising, so let us be quite clear that the trend of gas prices is upward.

Perhaps the only way in which Canadian domestic consumers can be protected over the long run against some of the impact of rising gas prices, is by participating in an arrangement whereby local and export markets are combined, in such a way that maximum economies of production and transmission are possible. The long-distance purchaser who must buy large volumes on a high load factor renders a double service. In assisting in financing a widespread system, he makes it possible for cities, towns, and hamlets in the gathering area to obtain ready access to gas supplies. Such a gathering system could never be financed if it were dependent on local markets only. In paying at predictable, rising and adequate prices, the long distance volume consumer *lowers* the average cost of gas to local users below what it would be if the local markets only were being served.

We have prepared for the Commission an example of the importance of a high load factor in making gas available at low prices. Using actual figures for the City of Lloydminster, we show that the existence of refineries in the area, with their year around use of gas at a high load factor, makes gas cheaper for the residents of Lloydminster than it

would be if purchases by the refineries were removed. This example is illustrated in detail and is submitted as Exhibit 1. In summary, the existence of a high load factor throughput permits gas to be delivered at a price of 18.3c per thousand. If the pipeline served the City of Lloydminster market only, with its low load factor, the unit price would be about 36c per thousand. The present arrangement will save consumers in this relatively small city about $50,000 per year. This situation will prevail to a greater or lesser extent in other areas.

One overriding consideration in favour of gas export is the business recession which we are facing. We have already shown that, if oil markets are not expanded, the independent producers in particular and the industry in general will be forced to curtail oil exploration, and the economy of Western Canada will suffer. Combined with the effect of a decline in general business, the impact could be very serious. On the other hand, markets for gas will help provide the petroleum industry with the revenues it needs to keep on developing the nation's resources. Moreover, gas export will give considerable employment during the pipeline construction period, will keep the pipe mills busy, and will stimulate the whole Canadian economy. When the Government of Canada is operating at a deficit to create employment, surely huge projects like this, financed by private enterprise, should be encouraged.

We want to be clearly and firmly on record in favour of immediate approval of expanded markets for gas. We have shown that gas reserves, when predictable allowance for expected future development and discoveries is made, are, and will be, ample. We have shown that residents of Canada will not suffer, but will *benefit* from export. Provided the public interest is adequately safeguarded, we see no difficulties in the export of gas. On the contrary, we see gas export and the economic activity that goes with it as a straightforward method of strengthening the Canadian economy in a difficult period. It will provide enduring national benefits as well. We feel that the Provincial and Federal governments should take early and positive action.

TAXATION AND FINANCE

Now, with your permission, we would like to comment briefly upon some matters relating to taxation and finance. Whether oil or gas holds more attraction to us, we cannot explore for either of them without adequate funds. To some extent we will be able to generate more cash out of earnings if certain principles regarding taxes are accepted and implemented.

The question of taxation in the petroleum industry was reviewed before the Royal Commission on Canada's Economic Prospects — The Gordon Commission — by several oil companies, and the Commission itself put in hand a study of taxation by an eminent accountant.* His conclusions as to taxation of the petroleum industry are submitted as Appendix 2 to our brief today.

In another study, prepared by the staff of the same Royal Commission, the authors had this to say:

> "In the petroleum industry the differing tax treatment in Canada and the United States with respect to such matters as depletion allowances and property costs — when combined with the ability of United States investors in the early stages of a development program to offset losses on Canadian operations against income otherwise taxable in the United States — would appear to give United States companies operating in Canada varying degrees of tax advantage compared to their Canadian counterparts."‡

In August 1957 the Canadian Petroleum Association, representing 97 per cent of the industry's production, submitted to the Government of Canada an extensive brief containing five specific proposals in the field of petroleum taxation. As members of the Canadian Petroleum Association, we endorse this submission, and we place it on the record of this Commission by including it as Exhibit 2.

It is, of course, well understood that taxation of the petroleum industry in Canada tends to favor companies based in the United States over a purely Canadian producer, and this and other taxation matters will no doubt occupy some of the Commission's time.

What we would like to do is to suggest some other possibilities in the broader field of finance which are important to us because they would

* Grant Glassco, "Certain Aspects of Taxation Relating to Investment in Canada by Non-Residents, Royal Commission on Canada's Economic Prospects, Queen's Printer (Ottawa: 1957).

‡ Brecker and Reisman, op. cit. p. 117 para. 2.

give us access to some new and willing sources of funds, but their importance goes far beyond the oil industry and relates to the energetic development of Canada as a whole.

In the first place we all recognize now that Canadian capital can finance vast undertakings. There are substantial sources of capital in Canada if they can be unlocked.

The independent producer of oil and gas relies in large part on risk capital supplied by investors. We are more vulnerable than a company with international sources of funds, because we can only raise new equity capital effectively when conditions in the Canadian petroleum industry are good, and in addition, investor confidence is high. When production is restricted, and the payout period becomes longer, the present worth of our reserves goes down, and our market value goes down with it, affecting investors across Canada. Under these conditions we cannot raise new equity capital on reasonable terms, even though we might have opportunities at such a time to use it to advantage.

In the United States, private individuals and companies not in the petroleum industry play an active role in supplying venture capital for exploration, not only in their own country but in Canada and elsewhere. Furthermore, nearly all this capital flows to the independent producers. It is desirable that potential investors in Canada as well should participate in our industry. We suggest that changes in our tax legislation may be the way to make this possible, and that the Commission might recommend such changes for the consideration of the appropriate authorities.

With respect to long term or borrowed capital, the assets of the life insurance companies and other institutions are large and expanding rapidly. May we suggest that the Commission give consideration to the advisability of recommending changes which would make more of these funds available to the oil and gas industry. For example, existing regulations might be altered to permit these institutions to make long-term loans against production, or to finance the purchase of proven reserves in the ground. If incentives are necessary to stimulate this type of investment, such incentives are worthy of study by the appropriate departments of the Government.

Some short-term loans are being made against production by the chartered banks, but they run only for periods up to four or five years. This term is not realistic when related to the lengthened pay-out periods brought about by the currently greatly reduced oil allowables, and presents an obstacle to the ability of an independent oil company to finance its

operations. If the chartered banks are not prepared to make medium term loans, we submit that the Industrial Development Bank, which was formed to fill such gaps in the country's financial structure, should enter this loaning field.

The revenues that will be created by vigorous and progressive action in these fields will not lie idle, but will spread throughout the economy of Canada. That portion of the earnings from oil and gas, which accrues to the independent companies, will certainly be fully employed. Building up idle cash is not one of our policies. We will be quick to use our available funds to explore for and develop new reserves, not only in this part of the country but in the northland, which we feel offers a challenge and great opportunities.

The proper incentives, and an active use of capital, will create an oil and gas industry in Canada which will bring great material benefits to the people of this country.

CONCLUSION

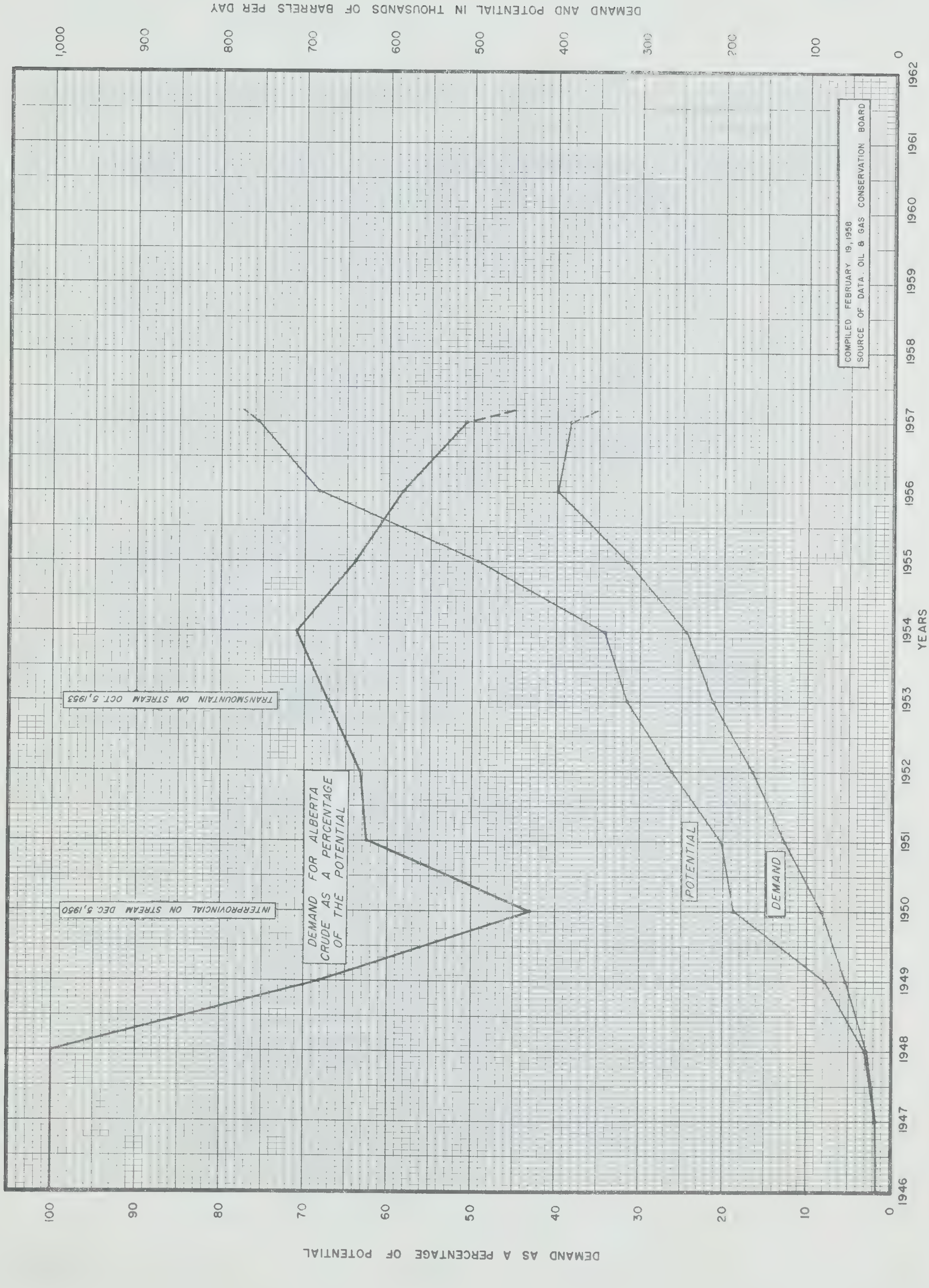
Our description of the manner in which an independent company does business was made with the sincere desire to add further to the Commission's understanding of the petroleum industry.

We have shown the Commission today how the independent oil companies have played an important part in the development of our industry in the past few years, in spite of the limitations of markets, the restriction of competitive opportunities, and the fact that Canadian capital was not as freely available as it might have been.

As independent producers, our interest is closely identified with the national interest. For this reason we have felt justified in making certain recommendations to the Commission. We will summarize them now.

> We urge strong representations at the highest Government levels to expand our logical United States markets for oil.
>
> We urge immediate approval of expanded markets for our surplus natural gas, with adequate protective measures for the Canadian people.
>
> We have outlined, and we strongly recommend, specific changes in the field of taxation and finance, which will help mobilize Canadian capital to develop our oil and gas resources, in the national interest.

APPENDIX I


DEMAND AND POTENTIAL IN THOUSANDS OF BARRELS PER DAY
DEMAND AS A PERCENTAGE OF POTENTIAL
YEARS
DEMAND FOR ALBERTA CRUDE AS A PERCENTAGE OF THE POTENTIAL
POTENTIAL
DEMAND
INTERPROVINCIAL ON STREAM DEC. 5, 1950
TRANSMOUNTAIN ON STREAM OCT. 5, 1953
COMPILED FEBRUARY 19, 1958
SOURCE OF DATA OIL & GAS CONSERVATION BOARD

CERTAIN ASPECTS OF TAXATION RELATING TO INVESTMENT IN CANADA BY NON-RESIDENTS

by

J. GRANT GLASSCO

of Clarkson, Gordon & Co., Chartered Accountants.

ROYAL COMMISSION ON CANADA'S ECONOMIC PROSPECTS CONCLUSIONS AS TO TAXATION OF THE PETROLEUM INDUSTRY

There is probably no field of Canadian industry in which taxation considerations are more complex than they are in the petroleum industry. While certain conclusions may be indicated by a brief study of this kind, the form and legal arrangements within the industry for joint ventures and acquisition of various types of property interests are so complex as to require a very detailed examination of the whole problem before reaching specific conclusions on which any change in legislation could satisfactorily be based. However, the limited study which has been made of the subject does indicate a number of broad principles which might be observed in dealing with the problem:

1. As in any other industry taxation should be imposed only upon the net profits. The system of allowances and deductions should be such as to give reasonable, if not absolute, assurance that all costs will be deductible, either directly or indirectly (such as through depletion allowances). Acquisition of land, exploration expenses and drilling expenses would all, in the absence of any right of deduction, represent capital expenditures. Our present legislation gives full recognition of the right to deduct exploration and drilling expenditures immediately up to the full amount of taxable income, but it does not, directly, allow deduction of property costs, with the exception of bonuses paid for unproductive government leases which are abandoned. Accordingly, under our present system the recovery of property costs can only be effected through depletion, but since the depletion system is based on percentage of income, rather than on cost, it does not in itself assure this result. Undoubtedly a system of cost depletion would provide greater assurance, but whether its over-all effect would be desirable or otherwise is a question

which must be considered from many angles. Unless there were adequate safeguards, the immediate effect of introducing cost depletion would probably be to encourage the transfer of producing properties at values related to established oil reserves, so that the new owners would become entitled to a higher basis for cost depletion than existing owners. It would also raise serious administrative problems.

2. In addition to providing reasonable assurance of the recovery of costs in arriving at taxable income, investors will no doubt believe that our tax system should provide some incentive for taking the risks inherent in the industry. Presumably the incentives offered should logically be greater in the case of an exploration programme than for the development of proven acreage.

   Our present scheme of depletion allowances is therefore such that a single allowance, computed on income, must serve the two-fold purpose of allowing cost recovery and supplying incentive for risk-taking. It may be too much to expect that it will fill this dual role satisfactorily in the widely different circumstances which are found in the industry.

3. The depletion allowances should be on the same footing for an exploration company as for a marketing or refining company having other income. The latter now enjoy some advantage.

4. Any decision as to the extent of deductions for cost of property (now limited to abandoned Crown leases which prove unproductive) would have to depend upon the method adopted for dealing with the depletion problem. However, there are strong arguments for extending these deductions to include the cost of permits and reservations acquired from governments.

5. While it is important to reduce, as far as possible, the competitive advantage which non-residents may have over residents in exploring for oil in Canada, this can hardly be approached from the basis that the Canadian system must match the most favourable scheme of concessions granted by any foreign country whose operators engage in exploration in Canada.

It would be presumptuous to suggest a scheme which would meet these and possibly other basic requirements, and do full justice to the industry in all of the varying circumstances and forms of organization

which are found. However, from the study which has been given to the matter, there are strong indications that the Canadian system of taxation would be improved by the adoption of a scheme of depletion allowances under which a major factor would either be gross income from production or income after operating expenses, thus discontinuing the present method of deducting all exploration and development expenses in arriving at the profit on which depletion is based. At least four advantages might well result from the change:

(a) Removal of the present dis-incentive to continued exploration after production has been obtained.

(b) It would go some distance towards making a Canadian company competitive with a United States company in the early stages of a programme.

(c) It would eliminate the present disability suffered by a pure exploration company, as compared with a marketing or refining company which obtains a higher base of depletion allowances through absorbing some of the exploration costs against the marketing income, rather than against the oil production income.

(d) As between exploration companies and those concentrating more on development of proven acreage, the greater incentive would be offered for taking risks.

However, in considering any new scheme of depletion, consideration would have to be given not only to incentives for exploration but also to the recovery of costs of acquiring proven acreage, including the investment which has already been made in property at prices which were no doubt influenced by the present scheme of taxation. The whole subject is of such complexity that any major change should only follow a most detailed examination, with the fullest opportunity for the industry to make representations.

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